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Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

ROBERT ORMAN, ***Petitioner,***
v.
CHARLES E. SCHWAB & CO., INC., ***Respondent.***

GORDON RUBENSTEIN, ***Petitioner,***
v.
QUICK & REILLY, INC., and
U.S. CLEARING CORP., ***Respondents.***

LEONARD M. BLAND, ***Petitioner,***
v.
OLDE DISCOUNT CORPORATION, ***Respondent.***

On Petition for Writ of Certiorari to the Supreme Court of Illinois

PETITION FOR WRIT OF CERTIORARI

CHARLES R. WATKINS
SUSMAN & WATKINS
Two First National Plaza, Ste. 600
Chicago, Illinois 60603
(312) 346-3466

MICHAEL B. HYMAN
CHRISTOPHER J. STUART
WILLIAM H. LONDON
MUCH SHELIST FREED DENENBERG AMENT BELL & RUBENSTEIN, P.C.
200 N. LaSalle St., Ste. 2100
Chicago, Illinois 60601
(312) 346-3100

TERRY ROSE SAUNDERS
Counsel of Record
LAW OFFICES OF TERRY ROSE SAUNDERS
30 N. LaSalle St., Ste. 3200
Chicago, Illinois 60602
(312) 346-4456

DANIEL M. HARRIS
30 S. Wacker Dr., Ste. 2900
Chicago, Illinois 60606
(312) 382-8930

Attorneys for Petitioners

Midwest Law Printing Co., Chicago 60610, (312) 321-0220

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QUESTION PRESENTED

Do federal securities laws pre-empt state common law damage remedies for a broker's breach of the fiduciary duty of loyalty to customers where state law is not inconsistent with federal law requirements?

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OPINIONS BELOW

The decision of the Illinois Supreme Court is not yet officially reported. It is reproduced in the Appendix to this Petition for Writ of Certiorari ("App.") at 1. The Illinois Appellate Court decision in *Orman v. Charles Schwab & Co., Inc.* is reported at 676 N.E.2d 241 (1st Dist. 1996) (App. 17). The decisions of the Chancery Court of Cook County (App. 36, 37) are not officially reported.

JURISDICTION

The Illinois Supreme Court filed its opinion and entered judgment on November 20, 1996. (App. 1). This Petition for Writ of Certiorari is filed pursuant to Supreme Court Rule 13. This Court has jurisdiction pursuant to 28 U.S.C. § 1257(a).

STATUTES AND REGULATIONS INVOLVED

This Petition for Writ of Certiorari raises the question whether the 1934 Securities Exchange Act, as amended, and regulations of the Securities and Exchange Commission pre-empt fiduciary duty common law remedies available to investors. Due to their length, the statutes and regulations involved are reproduced in pertinent part in the Appendix. (App. 38). These statutes and regulations are as follows:

1. The Supremacy Clause of the United States Constitution, Article VI, clause 2.
2. Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb.
3. Rule 10b-10, Confirmation of Transactions, 17 C.F.R. § 240.10b-10 (promulgated 1977).

4. Rule 10b-10, Confirmation of Transactions, 17 C.F.R. § 240.10b-10 (amended 1994).
5. Rule 11 Ac1-3, 17 C.F.R. § 240.11Ac1-3 (adopted November 2, 1994).

STATEMENT OF THE CASE

Petitioners Robert Orman, Gordon Rubenstein and Leonard Bland, individually and on behalf of customers of defendant brokers, each commenced a class action in the Circuit Court of Cook County, Illinois. Plaintiffs alleged that the defendant stockbrokers breached fiduciary duties and contracts by directing customer orders for execution to market makers who pay the brokers for sending their business to them. In violation of state law, the brokers neither disclosed this practice in advance, nor passed on these payments to their customers. The complaints seek to recover as damages the payments the brokers received for sending plaintiffs' stock trades to market makers who paid for the business.

The brokers call these payments "payment for order flow", although the payments have been characterized as "kickbacks" by those questioning their legality. Although we adopt here the brokers' terminology and refer to these payments as "payments for order flow", this does not alter the conflict the practice at issue creates for brokers, who act as an agent for a customer in executing the customer's order while aggregating customer orders for which they receive compensation from a market maker.

The practice of stockbrokers taking cash payments for directing customer orders to particular market makers

began in the 1980's. At the time, there was no SEC rule or regulation that mentioned this practice. In the mid-1980's, however, the National Association of Securities Dealers ("NASD") recommended to its members that stockbrokers should treat payments for order flow as "other remuneration" and disclose the payments on the back of their confirmation slips in accordance with SEC Rule 10b-10(a)(7)(iii).[1] Rule 10b-10 did not mention payment for order flow; and the SEC had not addressed the practice. Moreover, in announcing Rule 10b-10 in 1977, the SEC made clear that "[t]he Rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a particular transaction in securities." Securities Exchange Act Release No. 13,508 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,143, at 87,930 n. 28 (May 5, 1977). When plaintiffs commenced these actions in 1993, the SEC had not announced any rule governing payments for order flow.

A. Statutory and Regulatory History

In 1934, Congress enacted the Securities Exchange Act ("Exchange Act"), among other things, to implement a philosophy of full disclosure. By expressly preserving rights and remedies that existed under state law, Con-

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[1] The SEC promulgated Rule 10b-10 in 1977 to address the problem of "agency crosses in the over-the-counter market where the broker acts as agent for both the buyer and the seller." Securities Exchange Act Release No. 13,508 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,143 (May 5, 1977). Rule 10b-10 requires brokers to disclose on their confirmation slips whether they are receiving other remuneration. (App. 38).

gress made clear that state laws would continue to govern securities industry participants. Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a) provides: "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist in law or in equity." Since 1934, Congress has not suggested that the federal securities laws generally pre-empt state law fiduciary duties of an agent to act in its customer's best interests.[2]

In 1975, Congress amended the Exchange Act and reiterated the Act's basic goals, including fair dealing in securities and assuring that each investor obtained the best possible execution of his order. Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. (1975). The 1975 amendments also directed the SEC to facilitate the establishment of a national market system in accordance with the Exchange Act's objectives.

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[2] Indeed, in only one instance has Congress modified general common law fiduciary duties. In the 1975 amendments, Congress created a safe harbor for a fiduciary money manager, who, in the exercise of investment discretion with respect to an account, paid higher commissions to broker-dealers who provided brokerage or research services. Congress added Section 28(e) of the Exchange Act that pre-empted then-existing state or federal law that made such conduct a *per se* breach of fiduciary duty. Congress allowed such conduct so long as the manager determined the commission was in the investor's best interest and adequately disclosed his policies and practices with respect to commission payments. 15 U.S.C. § 78bb(e). This modification of state common law is not applicable here, but is significant because, in limiting state law fiduciary duty, this provision expressly recognized that state fiduciary duty law would otherwise have applied to such transactions and left room for state law regulation both in the future and where the manager did not act in his customer's best interests.

The SEC has repeatedly and consistently acknowledged the central role of state fiduciary duty law in regulating broker dealer conduct toward customers. Indeed, the SEC has noted that "[o]rdinarily, a fiduciary that uses the assets of its managed accounts for its own benefit would be subject to claims of a breach of fiduciary duty under state and federal law." Securities Exchange Act Release No. 34-30920, U.S. Equity Market Structure Study [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,012, at 82,908 n. 7 (July 14, 1992). And, the SEC has relied on common law agency principles (RESTATEMENT (SECOND) OF AGENCY, § 387 and § 424) in stating that a broker's duty to customers comes from the common law agency duty of loyalty, which obligates an agent to act exclusively in the principal's best interest. SEC Division of Market Regulation, "Market 2000: An Examination of Current Equity Market Developments," Study V, Best Execution (Jan. 1994).

In 1992, the SEC noted concern that the practice of order flow payments would interfere with the execution of customer orders and the fiduciary duty to obtain the best execution of a customer trade: "the practice raises the concern that a broker's decision on how to execute a customer's order is influenced by the payment of compensation by particular markets or market makers." Securities Exchange Act Release No. 34-30920, *supra*, at 82,919 (July 14, 1992).[3] In 1994, the SEC responded by

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[3] In 1993, the SEC sought a fuller debate on a proposed rule to require enhanced disclosures regarding payment for order flow or alternatives, including prohibiting payment for order flow. Securities Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934 (Oct. 13, 1993). The SEC again recognized

(continued...)

prospectively imposing a new disclosure requirement on brokers to inform their customers before opening an account and annually afterwards of their policies and practices with respect to payment for order flow.[4] The Commission thereby provided brokers with a way to eliminate—with respect to future transactions—the broker's conflict and exposure to claims for breach of the fiduciary duty of loyalty by requiring disclosure to, and consent of, a customer before a broker can accept payments in exchange for directing its customer's orders to a market maker. This case concerns exclusively *pre*-1994 events which are not governed by the SEC's new rule.

B. Proceedings in the Illinois Courts

After plaintiffs filed their complaints in the Circuit Court, the defendants moved to dismiss each complaint, contending that the federal securities laws pre-empted plaintiffs' claims. Both trial court judges granted defendants' motions and plaintiffs appealed. The three com-

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[3] (...continued)
that the availability of payments in return for order flow may color a broker's evaluation of the best opportunity for its customer and cited concerns that the acceptance of such a payment may be a breach of fiduciary duty. *Id.*

[4] The SEC amended Rule 10b-10 to include for the first time an express reference to and definition of "payment for order flow" and adopted new Rule 11Ac1-3 which requires brokers to inform their clients "in writing, upon opening a new account and on an annual basis thereafter," of their policies regarding payment for order flow, including "a detailed description of the nature of the compensation received" and "policies for determining where to route customer orders that are the subject of order flow." Rule 11Ac1-3, 17 C.F.R. § 240.11Ac1-3 (App. 40-41).

plaints were consolidated for purposes of appeal. On December 24, 1996, a majority of the Illinois appellate court affirmed, relying on decisions in similar actions brought in other state courts that state law claims are pre-empted.[5] The majority held that allowing plaintiffs' claims to survive would frustrate, if not destroy, the "federal goal" of "uniform" regulation of the securities markets. (App. 29). In a dissenting opinion, one justice of the appellate court concluded that, although federal law provided minimum disclosure requirements, nothing in the federal securities laws could prevent the plaintiffs from bringing actions for breach of fiduciary duty against agents who had secretly received and retained money from those to whom they sent their principals' business. (App. 31).

The Illinois Supreme Court allowed plaintiffs' petition for leave to appeal and, in an opinion issued on November 20, 1997, affirmed the appellate court's decision. The Illinois Supreme Court held that allowing plaintiffs' breach of fiduciary duty claims to proceed would obstruct Congress' intent to foster a National Marketing System by subjecting brokers to damages claims for breaches of state law fiduciary duties that were not expressly contained in the federal securities laws. The Illinois Supreme Court reasoned that: (1) Congress amended the Exchange Act in 1975 to increase competi-

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[5] *Dahl v. Charles Schwab & Co., Inc.*, 545 N.W.2d 918 (Minn.), *cert. denied*, 117 S.Ct. 176 (1996); *Guice v. Charles Schwab & Co., Inc.*, 89 N.Y.2d 31, 651 N.Y.S.2d 352, 674 N.E.2d 282 (1996), *cert. denied*, 117 S.Ct. 1250 (1997); *McKey v. Charles Schwab & Co., Inc.*, No. BC139314 (Cal.Super. Ct. Sept. 10, 1996); *Miller v. Charles Schwab & Co.*, No. BC137133 (Cal.Super.Ct. Sept. 10, 1996).

tion in the securities industry; (2) the SEC had determined that order flow payments overall had a positive competitive effect; and (3) the SEC in 1994, after the transactions of which plaintiffs complain, had adopted regulations that require brokers to disclose the practice of receiving order flow but not to pass through or disclose the amount of payments to customers. The court concluded that plaintiffs' damages claims were, therefore, pre-empted because they would require individualized apportionment that the SEC did not require. The decision of the Illinois Supreme Court is the subject of this petition for a writ of certiorari.

REASONS FOR GRANTING THE WRIT

The Illinois Supreme Court has decided an important question of federal pre-emption in a way that directly conflicts with relevant decisions of this Court and that contravenes Congress' intent as expressed in the "savings clause" of Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a). Moreover, the highest state courts of New York and Minnesota, on which the Illinois court relied, have also ignored the express language of Section 28(a) and have construed the doctrine of implied pre-emption in a way that sweeps aside state fiduciary duty laws.

Congress enacted the Securities Exchange Act of 1934 to promote disclosure to investors in the federal securities markets. In the Exchange Act, Congress made explicit its intention not to pre-empt the role of the states. When Congress amended the Exchange Act, it reaffirmed that it did not intend the federal securities laws to pre-empt state common law remedies. Section

28(a) of the Exchange Act provides: "The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity." As this Court has long recognized, "The section was plainly intended to protect, rather than to limit, state authority." *Leroy v. Great W. United Corp.*, 443 U.S. 172, 182 (1979). *See also, Matsushita Elec. Indus. Co. v. Epstein*, 116 S.Ct. 873, 882 (1996).

One well established area of state authority that Section 28(a) was designed to protect is the common law fiduciary duties of loyalty and disclosure, which require an agent to make full disclosure to the principal and act exclusively in the principal's best interest. RESTATEMENT (SECOND) OF AGENCY § 387 (1958). Payment for order flow implicates these duties. The broker's dual role, as both agent for the customer and an aggregator of customer orders for which the broker receives compensation from a market-maker, creates a conflict. The defendant brokers in this case profited from, but did not disclose, this conflict to their customers.

The Illinois Supreme Court concluded that, because the SEC had not banned payment for order flow or required brokers to disclose the amount of order flow payments received, plaintiffs' state law breach of fiduciary duty claims were pre-empted. The Illinois court reasoned that to allow these claims would frustrate Congress' intent, as reflected in the 1975 Amendments to the Exchange Act, to further a National Market System. This conclusion is wholly erroneous and should be re-examined. It elevates Congressional and regulatory silence to a position superior to Congress' explicit intent as evidenced in a statutory provision, namely Section 28(a), 15 U.S.C. § 78bb(a).

It is well-established that state laws are not pre-empted simply because they impose obligations that go beyond federal law and govern areas of behavior about which Congress has been "silent." *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 77 (1987); *Atherton v. F.D.I.C.*, 117 S.Ct. 666, 670 (1997). Only last term, this Court recognized that conduct that is not prescribed by Section 10(b) of the Exchange Act may still subject a securities trader to liability under state law for breach of a duty of loyalty. *United States v. O'Hagan*, 117 S.Ct. 2199, 2209 (1997).

Nothing in the Exchange Act itself suggests Congress intended federal silence on matters of potential securities law regulation to displace state common law breach of fiduciary duty claims. *See, e.g., United States v. O'Hagan, supra*. And any attempt to read pre-emption into a statute that contains a sweeping savings clause turns on its head this Court's recognition that "the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear intent of Congress." *Medtronic, Inc. v. Lohr*, 116 S.Ct. 2240, 2250 (1996), quoting from *Rice v. Sante Fe Elevator Corp.*, 331 U.S. 218, 230 (1947).

Moreover, nothing in the language or context of SEC regulations pre-empts plaintiffs' claims. No SEC regulations before 1994 mentioned payment for order flow. The fact that securities industry participants chose to construe Rule 10b-10, regarding information to be included on confirmations, to be applicable to order flow payments does not, without more, relieve brokers from liability for breach of fiduciary duty. Nothing in Rule 10b-10 purports to satisfy a broker's obligations under state fiduciary duty law, and the after-the-fact disclo-

sure on the back of a confirmation is not the kind of full disclosure necessary to obtain consent to conduct that would otherwise be a breach of the duty of loyalty or the duty of full disclosure.[6] The SEC itself stated at the time it announced Rule 10b-10: "The rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a particular transaction in securities." Securities Exchange Act Release No. 13,508 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,143, at 87,930 (May 5, 1977). Similarly, the Rule is not a "safe harbor" that defines the full extent of a broker's fiduciary duties to its customers.

In 1994, the SEC responded to the practice of payment for order flow by requiring brokers to disclose to a customer in advance the policies regarding payment for order flow, including the nature and source of the compensation, and the broker's policies for determining where to route customer orders. As the SEC acknowledged at the time, this approach is consistent with the overall philosophy of federal securities laws that "sunlight is the best disinfectant." Securities Exchange Act Release No. 34-34902, quoting L. Brandeis, *Other People's Money and How the Bankers Use It,* 92 (Frederick

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[6] See Note, *The Perils of Payment for Order Flow*, 107 Harv. L. Rev. 1675, 1685 (May 1994) (disclosures on confirmation slips do not justify broker retention of order flow payments because "the vague, small-print disclosure required by Rule 10b-10 does not adequately alert customers to the presence of payments for order flow" and "ex-post acquiescence is not the ex-ante agreement that agency law seems to mandate before the agent can keep profits derived from a transaction on behalf of his principal").

A. Stokes Co. ed. 1932). This response, however, does not in any way diminish plaintiffs' claims because the misconduct complained of here occurred before the SEC announced its Rule and because plaintiffs' claims are based on defendants' failure to make the advance disclosure that agency law (and now the SEC) mandates. Moreover, the SEC's response does not lessen the importance of the issue this case raises of courts' limiting traditional state court remedies despite a broad savings clause in a federal statute expressly preserving these remedies.[7]

The Illinois Supreme Court's decision rests on the serious misconception that state law is pre-empted because federal law does not require brokers to disclose the amount of the order flow payments they receive, yet plaintiffs' state law damage claims would require these amounts to be computed. But a Congressional intent to pre-empt a traditional state law remedy cannot be implied simply because the SEC, years after the fact, decided not to require precise calculations. The Illinois court's reading of Congressional intent is contrary to common sense. More importantly, this Court has long recognized that it is "difficult to believe that Congress would, without comment, remove all means of judicial recourse for those injured by illegal conduct." *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 251 (1984). This,

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[7] Contrary to the state court decisions, two federal district courts have considered the issue of payment for order flow and have held that federal law does not pre-empt customers' common law claims. *Thomas v. Charles Schwab & Co.*, 1995 U.S. Dist. LEXIS 12007 (W.D. La. July 12, 1995); *Dumont v. Charles Schwab & Co.*, 1995 U.S. Dist. LEXIS 5992, 1995 WL 262262 (E.D. La. May 3, 1995).

however, is precisely what the Illinois court has done. It has decided that Congress, without comment, wiped out an entire area of state law which has traditionally been sacrosanct. If allowed to stand, the decision of the court below would deprive investors of their traditional right to recover from a broker who has breached his fiduciary duty.

CONCLUSION

Petitioners respectfully ask this Court to issue a Writ of Certiorari in order to resolve the important questions of federalism and pre-emption raised by the decision of the Illinois Supreme Court.

Respectfully submitted,

CHARLES R. WATKINS
SUSMAN & WATKINS
Two First National Plaza, Ste. 600
Chicago, Illinois 60603
(312) 346-3466

MICHAEL B. HYMAN
CHRISTOPHER J. STUART
WILLIAM H. LONDON
MUCH SHELIST FREED DENENBERG
AMENT BELL & RUBENSTEIN, P.C.
200 N. LaSalle St., Ste. 2100
Chicago, Illinois 60601
(312) 346-3100

TERRY ROSE SAUNDERS
Counsel of Record
LAW OFFICES OF
TERRY ROSE SAUNDERS
30 N. LaSalle St., Ste. 3200
Chicago, Illinois 60602
(312) 346-4456

DANIEL M. HARRIS
30 S. Wacker Dr., Ste. 2900
Chicago, Illinois 60606
(312) 382-8930

Attorneys for Petitioners

February 18, 1998